

MACROECONOMICS

SIXTH EDITION

Andrew B. Abel

The Wharton School of the University of Pennsylvania

Ben S. Bernanke

Dean Croushore

Robins School of Business University of Richmond



Boston San Francisco New York
London Toronto Sydney Tokyo Singapore Madrid
Mexico City Munich Paris Cape Town Hong Kong Montreal



Detailed Contents

Preface xv

PART 1 Introduction 1

CHAPTER 1

Introduction to Macroeconomics 2

1.1 What Macroeconomics Is About 2

Long-Run Economic Growth 3

Business Cycles 4

Unemployment 5

Inflation 6

The International Economy 8

Macroeconomic Policy 9

Aggregation 10

1.2 What Macroeconomists Do 11

Macroeconomic Forecasting 11

Macroeconomic Analysis 12

Macroeconomic Research 13

BOX 1.1 Developing and Testing

an Economic Theory 14

Data Development 14

1.3 Why Macroeconomists Disagree 15

Classicals Versus Keynesians 16

A Unified Approach to Macroeconomics 18

CHAPTER 2

The Measurement and Structure of the National Economy 23

2.1 National Income Accounting: The Measurement of Production, Income, and Expenditure 23

In Touch with the Macroeconomy:

The National Income and Product Accounts 25

Why the Three Approaches Are Equivalent 26

2.2 Gross Domestic Product 27

The Product Approach to Measuring GDP 27

BOX 2.1 Natural Resources, the Environment, and the National Income Accounts 30

The Expenditure Approach to Measuring GDP 31

The Income Approach to Measuring GDP 34

2.3 Saving and Wealth 37

Measures of Aggregate Saving 37

The Uses of Private Saving 39

Relating Saving and Wealth 40

APPLICATION Wealth Versus Saving 42

2.4 Real GDP, Price Indexes, and Inflation 46

Real GDP 46

Price Indexes 48

BOX 2.2 The Computer Revolution

and Chain-Weighted GDP 48

BOX 2.3 Does CPI Inflation Overstate Increases in the Cost of Living? 51

2.5 Interest Rates 52

Real Versus Nominal Interest Rates 53

PART 2 **Long-Run Economic** Performance 61

CHAPTER 3

Productivity, Output, and Employment 62

3.1 How Much Does the Economy Produce? The Production Function 63

APPLICATION The Production Function of the U.S. Economy and U.S. Productivity Growth 64

The Shape of the Production Function 66

Supply Shocks 71

3.2	The	Dema	nd for	r Labor	72
J.4	TILE	Dema	HU IU.	Lavoi	//

The Marginal Product of Labor and Labor Demand: An Example 73

A Change in the Wage 75

The Marginal Product of Labor and the Labor Demand Curve 75

Factors That Shift the Labor Demand Curve 77 Aggregate Labor Demand 79

3.3 The Supply of Labor 79

The Income–Leisure Trade-off 80

Real Wages and Labor Supply 80

The Labor Supply Curve 83

Aggregate Labor Supply 84

APPLICATION Comparing U.S. and European Labor Markets 85

3.4 Labor Market Equilibrium 87

Full-Employment Output 89

APPLICATION Output, Employment, and the Real Wage During Oil Price Shocks 90

APPLICATION Technical Change and Wage Inequality 91

3.5 Unemployment 93

Measuring Unemployment 94

In Touch with the Macroeconomy:

Labor Market Data 95

Changes in Employment Status 95

How Long Are People Unemployed? 96

Why There Always Are Unemployed People 97

3.6 Relating Output and Unemployment: Okun's Law 99

Appendix 3.A The Growth Rate Form of Okun's Law 109

CHAPTER 4

Consumption, Saving, and Investment 110

4.1 Consumption and Saving 111

The Consumption and Saving Decision of an Individual 112

Effect of Changes in Current Income 114

Effect of Changes in Expected Future Income 114

APPLICATION Consumer Sentiment and Forecasts of Consumer Spending 115

Effect of Changes in Wealth 118

Effect of Changes in the Real Interest Rate 119

Fiscal Policy 121

In Touch with the Macroeconomy:

Interest Rates 122

APPLICATION A Ricardian Tax Cut? 125

4.2 Investment 127

The Desired Capital Stock 127

Changes in the Desired Capital Stock 130

APPLICATION Measuring the Effects of Taxes on Investment 134

From the Desired Capital

Stock to Investment 135

Investment in Inventories and Housing 137

BOX 4.1 Investment and the Stock Market 138

4.3 Goods Market Equilibrium 139

The Saving-Investment Diagram 140

APPLICATION Macroeconomic Consequences of the Boom and Bust in Stock Prices 144

Appendix 4.A A Formal Model of Consumption and Saving 156

CHAPTER 5

Saving and Investment in the Open Economy 173

5.1 Balance of Payments Accounting 174

The Current Account 174

In Touch with the Macroeconomy:

The Balance of Payments Accounts 176

The Capital and Financial Account 177

The Relationship Between the Current Account and the Capital and Financial Account 179

BOX 5.1 Does Mars Have a Current Account Surplus? 181

Net Foreign Assets and the Balance of Payments Accounts 181

APPLICATION The United States as International Debtor 183

5.2	Goods Market Equilib	rium
	in an Open Economy	184

5.3 Saving and Investment in a Small Open Economy 185

The Effects of Economic Shocks in a Small Open Economy 189

5.4 Saving and Investment in Large Open Economies 191

APPLICATION The Impact of Globalization on the U.S. Economy 193

APPLICATION Recent Trends in the U.S. Current Account Deficit 196

5.5 Fiscal Policy and the Current Account 199

The Critical Factor: The Response of National Saving 200

The Government Budget Deficit and National Saving 201

APPLICATION The Twin Deficits 202

CHAPTER 6 Long-Run Economic Growth 212

6.1 The Sources of Economic Growth 213

Growth Accounting 215

APPLICATION The Post-1973 Slowdown in Productivity Growth 217

APPLICATION The Recent Surge in U.S. Productivity Growth 220

6.2 Growth Dynamics: The Solow Model 223

Setup of the Solow Model 224

The Fundamental Determinants of Long-Run Living Standards 231

APPLICATION The Growth of China 236

Endogenous Growth Theory 238

6.3 Government Policies to Raise Long-Run Living Standards 240

Policies to Affect the Saving Rate 240

Policies to Raise the Rate of Productivity Growth 241

CHAPTER 7

The Asset Market, Money, and Prices 247

7.1 What Is Money? 247

BOX 7.1 Money in a Prisoner-of-War Camp 248

The Functions of Money 248

Measuring Money: The Monetary Aggregates 250

In Touch with the Macroeconomy:

The Monetary Aggregates 251

The Money Supply 251

BOX 7.2 Where Have All the Dollars Gone? 252

7.2 Portfolio Allocation and the Demand for Assets 253

Expected Return 254

Risk 254

Liquidity 254

Time to Maturity 255

Asset Demands 256

7.3 The Demand for Money 256

The Price Level 257

Real Income 257

Interest Rates 258

The Money Demand Function 259

Other Factors Affecting Money Demand 260

Elasticities of Money Demand 261

Velocity and the Quantity Theory of Money 262

APPLICATION Financial Regulation, Innovation, and the Instability of Money Demand 264

7.4 Asset Market Equilibrium 266

Asset Market Equilibrium: An Aggregation Assumption 266

The Asset Market Equilibrium Condition 268

7.5 Money Growth and Inflation 269

APPLICATION Money Growth and Inflation in European Countries in Transition 270

The Expected Inflation Rate and the Nominal Interest Rate 272

APPLICATION Measuring Inflation Expectations 273

PART 3 Business Cycles and Macroeconomic Policy 281

CHAPTER 8 Business Cycles 282

8.1 What Is a Business Cycle? 283

8.2 The American Business Cycle: The Historical Record 285

The Pre–World War I Period 285
The Great Depression and World War II 285
Post–World War II U.S. Business Cycles 287
The "Long Boom" 288
Have American Business Cycles
Become Less Severe? 288

8.3 Business Cycle Facts 290

The Cyclical Behavior of Economic Variables: Direction and Timing 290 Production 291 In Touch with the Macroeconomy:

Leading Indicators 292

Expenditure 294

Employment and Unemployment 295

Average Labor Productivity and the Real Wage 297

Money Growth and Inflation 298

Financial Variables 299

International Aspects of the Business Cycle 300

8.4 Business Cycle Analysis: A Preview 301

BOX 8.1 The Seasonal Cycle and the Business Cycle 301

Aggregate Demand and Aggregate Supply: A Brief Introduction 302

CHAPTER 9

The IS-LM/AD-AS Model: A General Framework for Macroeconomic Analysis 310

9.1 The FE Line: Equilibrium in the Labor Market 311

Factors That Shift the FE Line 312

9.2 The IS Curve: Equilibrium in the Goods Market 313

Factors That Shift the IS Curve 315

9.3 The *LM* Curve: Asset Market Equilibrium 317

The Interest Rate and the Price of a Nonmonetary Asset 318

The Equality of Money Demanded and Money Supplied 318

Factors That Shift the LM Curve 321

9.4 General Equilibrium in the Complete *IS–LM* Model 325

Applying the IS–LM Framework: A Temporary Adverse Supply Shock 326

APPLICATION Oil Price Shocks Revisited 328

BOX 9.1 Econometric Models and Macroeconomic Forecasts for Monetary Policy Analysis 329

9.5 Price Adjustment and the Attainment of General Equilibrium 330

The Effects of a Monetary Expansion 330 Classical Versus Keynesian Versions of the *IS-LM* Model 334

9.6 Aggregate Demand and Aggregate Supply 336

The Aggregate Demand Curve 336
The Aggregate Supply Curve 338
Equilibrium in the *AD–AS* Model 341
Monetary Neutrality in the *AD–AS* Model 341

Appendix 9.A Worked-Out Numerical Exercise for Solving the IS-LM/AD-AS Model 351

Appendix 9.B Algebraic Versions of the *IS-LM* and *AD-AS* Models 353

CHAPTER 10

Classical Business Cycle Analysis: Market-Clearing Macroeconomics 360

10.1 Business Cycles in the Classical Model 361

The Real Business Cycle Theory 361

APPLICATION Calibrating the Business Cycle 364

Fiscal Policy Shocks in the Classical Model 371

Unemployment in the Classical Model 375

Household Production 377

10.2 Money in the Classical Model 378

Monetary Policy and the Economy 378

Monetary Nonneutrality and Reverse Causation 378

The Nonneutrality of Money: Additional
Evidence 379

10.3 The Misperceptions Theory and the Nonneutrality of Money 380

Monetary Policy and the

Misperceptions Theory 383
Rational Expectations and the Role of Monetary Policy 385
BOX 10.1 Are Price Forecasts Rational? 387

Appendix 10.A Worked-Out Numerical Exercise for Solving the Classical *AD-AS* Model with Misperceptions 395

Appendix 10.B An Algebraic Version of the Classical *AD–AS* Model with Misperceptions 396

CHAPTER 11

Keynesianism: The Macroeconomics of Wage and Price Rigidity 398

11.1 Real-Wage Rigidity 399

Some Reasons for Real-Wage Rigidity 399
The Efficiency Wage Model 400
Wage Determination in the
Efficiency Wage Model 401
Employment and Unemployment in
the Efficiency Wage Model 402
Efficiency Wages and the FE Line 404
BOX 11.1 Henry Ford's Efficiency Wage 405

11.2 Price Stickiness 406

Sources of Price Stickiness: Monopolistic Competition and Menu Costs 406

11.3 Monetary and Fiscal Policy in the Keynesian Model 412

Monetary Policy 412 Fiscal Policy 416

11.4 The Keynesian Theory of Business Cycles and Macroeconomic Stabilization 419

Keynesian Business Cycle Theory 419
Macroeconomic Stabilization 422

APPLICATION The Zero Bound 424

Supply Shocks in the Keynesian Model 427

BOX 11.2 DSGE Models and the Classical-Keynesian Debate 429

Appendix 11.A Labor Contracts and Nominal-Wage Rigidity 436

Appendix 11.B Worked-Out Numerical Exercise for Calculating the Multiplier in a Keynesian Model 439

Appendix 11.C The Multiplier in the Keynesian Model 441

PART 4 Macroeconomic Policy: Its Environment and Institutions 443

CHAPTER 12

Unemployment and Inflation 444

12.1 Unemployment and Inflation: Is There a Trade-Off? 445

The Expectations-Augmented Phillips Curve 447
The Shifting Phillips Curve 451
Macroeconomic Policy and the Phillips Curve 455
BOX 12.1 The Lucas Critique 456
The Long-Run Phillips Curve 457

12.2 The Problem of Unemployment 458

The Costs of Unemployment 458
The Long-Term Behavior of the
Unemployment Rate 459

12.3 The Problem of Inflation 462

The Costs of Inflation 462

BOX 12.2 Indexed Contracts 464

Fighting Inflation: The Role of Inflationary Expectations 466

BOX 12.3 The Sacrifice Ratio 468

The U.S. Disinflation of the 1980s and 1990s 469

CHAPTER 13

Exchange Rates, Business Cycles, and Macroeconomic Policy in the Open Economy 476

13.1 Exchange Rates 477

Nominal Exchange Rates 477

Real Exchange Rates 478

Appreciation and Depreciation 480

Purchasing Power Parity 480

BOX 13.1 McParity 481

The Real Exchange Rate and Net Exports 483

APPLICATION The Value of the Dollar and U.S. Net Exports 485

13.2 How Exchange Rates Are Determined: A Supply-and-Demand Analysis 487

In Touch with the Macroeconomy:

Exchange Rates 487

Macroeconomic Determinants of the Exchange Rate and Net Export Demand 489

13.3 The *IS-LM* Model for an Open Economy 492

The Open-Economy IS Curve 493

Factors That Shift the Open-Economy IS Curve 495

The International Transmission of Business Cycles 498

13.4 Macroeconomic Policy in an Open Economy with Flexible Exchange Rates 499

A Fiscal Expansion 499

A Monetary Contraction 502

13.5 Fixed Exchange Rates 504

Fixing the Exchange Rate 505

Monetary Policy and the Fixed Exchange Rate 508

Fixed Versus Flexible Exchange Rates 511

Currency Unions 511

APPLICATION European Monetary Unification 512

APPLICATION Crisis in Argentina 515

Appendix 13.A Worked-Out Numerical Exercise for the Open-Economy *IS-LM* Model 523

Appendix 13.B An Algebraic Version of the Open-Economy IS-LM Model 526

CHAPTER 14

Monetary Policy and the Federal Reserve System 529

14.1 Principles of Money Supply Determination 530

The Money Supply in an All-Currency Economy 530

The Money Supply Under Fractional Reserve Banking 531

Bank Runs 534

The Money Supply with Both Public Holdings of Currency and Fractional Reserve Banking 535

Open-Market Operations 537

APPLICATION The Money Multiplier During the Great Depression 538

14.2 Monetary Control in the United States 541

The Federal Reserve System 541

The Federal Reserve's Balance Sheet and Open-Market Operations 542

Other Means of Controlling the Money Supply 543

Intermediate Targets 547

Making Monetary Policy in Practice 550

14.3 The Conduct of Monetary Policy: Rules Versus Discretion 552

BOX 14.1 The Credit Channel of Monetary Policy 553

BOX 14.2 The Taylor Rule 554

The Monetarist Case for Rules 555

Rules and Central Bank Credibility 557

APPLICATION Money-Growth Targeting and Inflation Targeting 563

Other Ways to Achieve Central Bank Credibility 566

CHAPTER 15

Government Spending and Its Financing 573

15.1 The Government Budget: Some Facts and Figures 573

Government Outlays 573

Taxes 575

Deficits and Surpluses 579

15.2 Government Spending, Taxes, and the Macroeconomy 581

Fiscal Policy and Aggregate Demand 581 Government Capital Formation 583 Incentive Effects of Fiscal Policy 584

APPLICATION Labor Supply and Tax Reform in the 1980s 586

15.3 Government Deficits and Debt 589

The Growth of the Government Debt 589

APPLICATION Social Security: How Can It Be Fixed? 591

The Burden of the Government Debt on Future Generations 594

Budget Deficits and National Saving: Ricardian Equivalence Revisited 594

Departures from Ricardian Equivalence 597

15.4 Deficits and Inflation 598

The Deficit and the Money Supply 598
Real Seignorage Collection and Inflation 600

Appendix 15.A The Debt-GDP Ratio 609

Appendix A

Some Useful Analytical Tools 610

A.1 Functions and Graphs 610
A.2 Slopes of Functions 611
A.3 Elasticities 612
A.4 Functions of Several Variables 613
A.5 Shifts of a Curve 614
A.6 Exponents 614
A.7 Growth Rate Formulas 614
Problems 615

Glossary 617

Name Index 629

Subject Index 631